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Presentation of the Financial Stability Review of the Banque de France devoted to Valuation

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Let me start by congratulating the Banque de France for this impressive issue of the Financial Stability Review. It couldn't be more timely and right to the point. Valuation issues are at the centre of the current crisis and, certainly, understanding them better will be one of the pillars with which we will be able to build up the new regulatory framework of the future.

The current crisis has revealed a series of flaws in various areas of the international financial system. One topic on which regulators, supervisors and the industry are focusing is the application of fair value, especially when there are no deep and liquid markets.

Another topic is the interaction between valuation and the procyclicality of the financial system.

The adverse consequences of procyclicality tend to be more intense at times, as at present, when the interplay between asset valuation and leverage has become more important. If valuation methods tend to introduce incentives to increase leverage and mispricing risks, the adjustment process when economic conditions change will be more pronounced, amplifying its adverse impact on the economy.

Fair value would need to be perfected in several areas. In particular, it should allow a better evaluation of risks and profits over the business cycle and it should be compatible with promoting financial stability.

Pros and cons of fair value

The advantages of fair value are clear:

a) fair value has proven to be the only method capable of offering a transparent, relevant and reliable valuation of a series of financial products (e.g. derivatives)

b) fair value offers a closer view of the actual situation of financial markets which is closer to the view institutions use for management purposes

c) fair value is associated with greater market discipline

However, no valuation method is free from limitations:

a) there are not always active markets, and prices are therefore not always available for use in applying fair value which means that estimating fair value involves the use of valuation methods, which in turn implies some subjectivity in their design

b) When there are incentives to manipulate the information reported to the markets, the use of valuation models opens up the possibility of institutions cherry-picking specific parameters or assumptions, thereby accentuating information asymmetry problems

c) Fair value increases volatility on bank balance sheets, on profit and loss accounts, and consequently on the levels of regulatory capital that banks must hold. This would intensify the procyclicality of financial markets

d) As a result of the greater volatility induced in banks' profits and loss accounts, the use of fair value might create perverse incentives in banks' management decisions, placing excessive emphasis on the short term, in particular if compensation is linked to short term accounting results

Furthermore, the current financial crisis has highlighted significant weaknesses regarding the implementation of fair value in at least three areas:

1) shortcomings in the design of valuation models, which have not properly captured the characteristics of the most complex products

2) it has highlighted governance problems since systems have not been appropriately designed to verify and test the valuations made

3) the information reported to the market has not been understood

Is it possible to improve fair value?

A return to valuation at cost is neither feasible nor desirable. Yet the application of fair value under very adverse financial market conditions has highlighted significant limitations which bear negatively on financial stability. Improving its functioning would appear to be necessary. I turn now to describing two of the potential avenues that can be explored in order to improve fair value: dynamic provisions and valuation reserves.

Dynamic provisions

The first mechanism that might help improve fair value is dynamic provisions. These are a good measurement of the fair value of a loan portfolio. Conceptually, provisions should be understood as adjustments to the book value of the loans. These adjustments take into consideration the impact that the credit risk borne by the institution entails for these loans.

Therefore, a correct valuation of loans in the credit portfolio should also include the factors of risk which, though they have not been specified at the level of individual loans, can in fact be quantified through statistical procedures. The absence of value corrections for these reasons distorts the true and fair view that financial information should provide, hampering decision-making by investors.

Dynamic provisions, as an approximation to the fair value of banks' loan portfolios, mitigate the fact that, at favourable times in the cycle, risks are taken and build up but are only disclosed with a delay in financial institutions' profit and loss accounts.

Valuation reserves[1]

As a second improvement in fair value, institutions could set aside valuation reserves for those more complex structured products that are mark-to-model. These reserves would entail the recognition, in accounting terms, of the uncertainty associated with the calculation of fair value under specific circumstances.

Banks should have different estimates of the fair value of the instrument depending on the various values these inputs may take given different assumptions and scenarios. Institutions should reflect in their accounts the estimation of the fair value of the instrument, along with a valuation reserve that reflects the uncertainties surrounding this estimation.

The valuation reserves should be objective and transparent. Moreover, and this is most important, they should be symmetrical. That is, these reserves have to function both in good times and in bad times. In other words, it is not a question of generating buffers to face difficulties, but of improving the valuation of complex financial instruments by explicitly and transparently incorporating the uncertainty that surrounds the valuation.

Fair value implementation problems do not emerge ex novo when economic and financial conditions turn adverse; they already exist in good times. It is precisely in these periods when agents act with excessive optimism, valuing risks inappropriately. As the current financial difficulties clearly show, the losses being posted now stem from the excesses committed in the prior years of strong economic growth.

There are two further arguments in favour of valuation reserves and of dynamic provisions. If managers fail to take into account risks and profits over the cycle in their decision-making, the introduction of the proposed changes to fair value will help them do so. And that is good for risk management while, at the same time, investors are offered better information.

Valuation reserves and dynamic provisions are mechanisms that also contribute to mitigating the current procyclicality of accounting rules. Both measures favour a longer-term view, and in

[1] An example of how these valuation reserves could work is the following: In the valuation of complex models, the assumptions regarding asset correlations are very important and there is significant uncertainty on how and at what speed those correlations might change. Therefore, the idea would be to incorporate such an uncertainty in the valuations. In good times, when risk premiums and correlations are very low, the valuation reserve would increase while in bad times, when risk premiums and correlations overshoot, valuation reserves will decline. Alternatively, we would be marking down some complex (i.e. difficult to value) financial products in good times and marking them up in bad times. In a sense, it is an extension of the dynamic provision philosophy to other financial products.

particular one "through the cycle", both for managers and for those who need to evaluate the risk profile of banks.

General principles for the review of fair value

Beyond the specific instruments that may be considered, there is a series of general guiding principles that are relevant for reviewing fair value:

1) Search for better valuations

This principle should apply both to the more quantitative aspects referring to valuation models and as regards providing a more realistic view of the risks and profits associated with business activity throughout the cycle (e.g. through dynamic provisions and valuation reserves).

2) Minimise the procyclical impact induced by fair value

It should be acknowledged that, during the favourable phases in the cycle, financial market participants display a natural behaviour that leads them to build up a series of risks which, when the situation turns adverse, tend to materialise. Accounting rules should not encourage this type of behaviour. From the standpoint of the application of fair value, the use of dynamic provisions and of valuation reserves may contribute to mitigating such risks.

3) Governance

Both quantitative and qualitative aspects are relevant in the implementation of valuation models. Sufficient resources should be set aside, and models should be revised and tested by independent units and subjected to different stress tests, among other considerations.

4) Transparency

Investors need to be able to receive the necessary information. It will not only be important to know the volume of exposures valued by means of fair value, but also matters relating to the valuation method and inputs used, to the assumptions made and to those aspects that may contribute to users' better understanding of the financial information.

Conclusion

Fair value is the best standard for providing final users of financial statements with relevant, reliable and comparable information. However, fair value needs to be improved in order to strengthen the relevance, reliability and comparability of information.

This can be done through two specific mechanisms (dynamic provisions and valuation reserves) within the framework of some more general guiding principles for this review process.

Both share important characteristics that are relevant in terms of their effectiveness and usefulness for market participants: objectiveness, transparency and symmetry throughout the business cycle.

While fair value is a clear step forward when compared, for instance, with cost valuation, the current crisis very clearly shows that it is by no means the end of the road. To continue along it, we need to effectively engage in a multilateral dialogue among accountants, regulators, supervisors and market participants so as to incorporate the much needed macro-prudential dimension both in financial regulation and accounting standards.